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SUBJECT: ECONOMIC STUDY SEES BENEFITS TO FTA

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Summary  
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1. (SBU) A U.S.-Egypt Free Trade Agreement (FTA) would be politically and economically beneficial for both Egypt and United States, according to a new study by the Washington-based Institute for International Economics (IIE). The authors assert that the timing is right for Egypt to conclude an FTA modeled on the Central American Free Trade Agreement (CAFTA) and other recently concluded FTAs. As an FTA partner, Egypt would likely reap significant economic gains and greater leverage for implementing its economic reform policies. For the U.S., the gains would be primarily political -- helping to anchor Egyptian reforms that could have positive spillover effects in the region. While Egypt would benefit from an FTA that covered trade in goods only, IIE's simulation studies show that Egypt would benefit substantially more from an agreement that also removed all non-tariff barriers. IIE's conclusion that an FTA would create significant economic benefits for Egypt lends credibility and support to those inside of government who are pushing hard for an FTA. End summary.

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Positive Environment for U.S.-Egypt FTA  
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2. (U) The May 2005 IIE study, "Anchoring Reform with A U.S.-Egypt Free Trade Agreement," by prominent Egyptian economist Ahmed Galal and Robert Z. Lawrence posited that the timing and environment are ripe for a U.S.-Egypt FTA. Egypt recently entered into two major free trade agreements: one with the European Union, which has not yet shown a major impact; and a second, Greater Arab Free Trade Agreement (GAFTA), which is just now beginning to show results. Moreover, the new government, under PM Nazif, is implementing serious economic reforms, which are necessary to ensure the success of comprehensive trade agreements. The conclusion of these important trade agreements and the government's economic reform program have created a positive environment for the implementation of a future U.S.-Egypt FTA.

3. (U) The authors note that a U.S.-Egypt FTA would likely resemble recent U.S. trade agreements, such as CAFTA and the FTAs with Morocco and Chile. The agreement with Egypt could be relatively "shallow" if it addressed only trade in goods or relatively "deep" if it sought a more comprehensive integration, including provisions on non-tariff trade barriers, administrative practices, services, investment, intellectual property, and rules affecting domestic regulatory practices and standards.

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Economic Benefits for Egypt  
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4. (U) According to the IIE study, a deep integration would be more beneficial for both the U.S. and Egypt. Bilateral trade at its current level, however, is much more important for Egypt. (Note: According to GOE statistics, Egypt's exports to the U.S. were \$4.39 billion in 2004, 35.7% of its total exports. In comparison, U.S. exports to Egypt in 2004 amounted to \$2.96 billion, only 0.37% of total U.S. exports. End note.) Therefore, the greater access to the U.S. market resulting from an FTA would likely create a much larger economic gain for Egypt than for the U.S., according to the authors.

5. (U) Beyond the economic gains from trade expansion that Egypt would reap in a shallow FTA, a deeper FTA would encourage greater foreign investment, help attract capital at more favorable terms, and help boost reform. A deeper integration would require harmonization of a number of

policies and standards, which also could help the Egyptian government politically as it tried to encourage domestic reforms in the economic sector. However, because of the wide discrepancy in the levels of development between the two nations, the authors believe that a phasing in of the rules and standards of an FTA would be necessary to avoid unfairly disadvantaging Egypt's local producers.

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Political Benefits for the U.S.  
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16. (U) Unlike Egypt, which could reap significant economic benefits from an FTA, the authors foresee primarily political rather than economic benefits for the U.S. The main economic gains would come from a diversion-avoidance effect, which would help correct the diversion from U.S. exports to EU exports that began when Egypt signed its trade agreement with the EU. The real benefit to the U.S., however, would be the promotion of domestic reforms in Egypt and, if successful, a demonstration effect with possible spillover to other countries in the Middle East.

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The Elements of a Likely FTA  
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17. (U) Referring to FTAs already concluded with the U.S., IIE speculates on the elements of a likely FTA with Egypt. These would likely include:

- Immediate elimination of tariffs on a majority of products, with the remaining tariffs eliminated within 10 to 15 years.
- Phase-out of all agricultural tariffs within 15 years, with carve outs for particularly sensitive products.
- A "negative list" approach to services whereby all service sectors are opened up unless specifically excluded in the agreement.
- Investment rules guaranteeing equal treatment for U.S. investors.
- Requirements for transparency and public comment in lawmaking and regulation pertaining to trade and investment.
- Criminal penalties for corruption and bribery.
- Laws regulating government procurement.
- Provisions for technical standards and sanitary and phyto-sanitary standards.
- Protection and enforcement of trademarks, copyrights and patents with criminalization of end-user piracy.

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Economic Impact of Shallow and Deep Agreements  
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18. (U) Based on a "static competitive applied general equilibrium" model of the Egyptian economy, IIE simulated the effects of a "shallow integration" agreement and a "deep integration" agreement. Both simulations assumed full implementation of the EU and GAFTA agreements. The results show economic gains in both scenarios, with significantly larger gains in a deep integration scenario:

Macroeconomic Indicators	Shallow	Deep
	(% Change)	
Household Welfare	0.16	1.63
Real GDP	1.79	2.82
Consumer Price Index	-0.16	-1.60
Real Exchange Rate	2.62	3.21
Returns to Capital	-0.42	0.84
Returns to Labor	1.99	3.00

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Negotiation Strategies and Synergies  
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19. (U) The authors note that the findings of their study have important implications for each side's negotiating strategy and dealings with domestic opponents to an FTA. For Egypt, an FTA could result in improved market access, increased foreign direct investment, enhanced consumer choice, better regional integration, and further reform. But to gain all these benefits, the GOE would have to be willing to make more, rather than fewer, commitments. The authors suggest that Egypt should seek to diverge from the standard commitments required under a U.S.-style FTA only when the demands diverge from Egypt's development or reform needs.

10. (U) For the U.S., the authors argue that it should not link the announcement of FTA negotiations to an unspecified level of reform undertaken by Egypt prior to negotiations. They argue that reform might be better advanced by anchoring it to the requirements of an FTA. Additionally, the authors warn that focusing on the narrow interests of particular U.S. companies that have large stakes in the Egyptian market

(they cite pharmaceutical firms) may prove to be a pitfall. They argue that where these narrow interests conflict with Egypt's economic development needs, the USG should be prepared to be flexible and look at the broader interests of both countries.

11. (U) The authors suggest that for Egypt, agriculture, not manufacturing, would face the greatest adjustment pressures from an FTA. To gain the support of potential opponents in the agricultural and other sectors, they recommend the use of phase-ins and special safeguards to cushion the impact of an FTA on those most adversely affected. They also suggest that the U.S. might provide financial assistance to ease the transition process. As for political opposition in the U.S., the authors contend it should not be significant. They note that a projected increase in exports of \$2 billion under an FTA would increase garment exports only \$155 million. This increase would have a negligible impact on the U.S. labor market, even on the textiles industry, which would be most adversely affected by an FTA with Egypt.

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Comment  
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12. (SBU) Trade agreements have traditionally been viewed with suspicion in Egypt. Major opponents include those in state-run and protected industries who fear that such agreements will reduce protective tariffs and lead to ruinous competition and increased unemployment. As the possibility of an FTA grows more real, we can expect the opponents of freer trade and greater economic reform to play on the public's fears and ignorance. This study by IIE, a prominent international think tank, will inject some economic reality into the debate. Its conclusion that an FTA with the U.S. would create significant economic benefits for Egypt lends credibility and support to those inside of government who are pushing hard for an FTA. End comment.